

therefore, does not discriminate against interstate commerce.

The taxpayers contend the tax discriminates against interstate commerce because it creates multiple burdens to which local commerce is not exposed. The Court rejected the multiple burden argument when discussing apportionment.

D. Fair Relationship to Services Provided by the State

The test of the tax's fair relationship to the benefits enjoyed is whether the state has given anything for which it can ask for something in return (*Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940)). This test is closely related to whether the interstate activity has a substantial nexus with the state (*Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 625-26 (1981)). The measure of the tax must be reasonably related to the extent of the contact with the state because

the activity and its participants may properly be made to bear a just portion of the tax burden.

The measure of the tax — the percentage of Wisconsin sales — need not be in precise proportion to the services provided in Wisconsin. A reasonable relation is required, and that standard is met here. The tax is imposed on calls originating from and billed in Wisconsin. The taxpayers are all incorporated, organized, or doing a substantial share of their business in Wisconsin. They enjoy police and fire protection and other benefits of doing business within the state. Deference is accorded the legislature's determination of the appropriate level of taxation. The tax is assessed in proportion to the companies' sales in Wisconsin. The Court concluded the sales tax is reasonably related to the services provided by Wisconsin.

Use Tax

Lastly, the taxpayers argue that "the use tax, which would be imposed in the absence of a sales tax, is invalid for the same reasons that the sales tax is invalid." Section 77.52(3), Wis. Stats., provides that "[t]he taxes imposed by this section may be collected from the consumer or user." The Court has concluded that their attack on s. 77.52(2)(a)4 is without merit and therefore rejects their challenge to s. 77.52(3).

The taxpayers have not met their burden of proving s. 77.52(2)(a)4, Wis. Stats., unconstitutional beyond a reasonable doubt. The Court of Appeals therefore affirmed the decision of the Circuit Court.

The taxpayers have appealed this decision to the Supreme Court.

TAX RELEASES

("Tax Releases" are designed to provide answers to the specific tax questions covered, based on the facts indicated. However, the answer may not apply to all questions of a similar nature. In situations where the facts vary from those given herein, it is recommended that advice be sought from the Department. Unless otherwise indicated, Tax Releases apply for all periods open to adjustment. All references to section numbers are to the Wisconsin Statutes unless otherwise noted.)

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INDIVIDUAL INCOME TAXES

1. Allocation of Death Benefit Exclusion Between Capital Gain and Ordinary Income Parts of a Lump-Sum Distribution

Statutes: section 71.05(1)(a)8, 1983 Wis. Stats.

Note: See the Tax Release titled "Treatment for Capital Gain Portion of a Lump-Sum Distribution From a Retirement Plan or Profit Sharing Plan" in *Wisconsin Tax Bulletin* #34.

Facts and Question: During 1984, Taxpayer A received a lump-sum distribution from her deceased spouse's qualified retirement plan. The 1984 Form 1099-R issued to Taxpayer A reported \$16,000 of the distribution as taxable income: \$12,000 allocated to ordinary income and \$4,000 allocated to capital gain income. Taxpayer A elected to figure her federal tax on the distribution using the 10-year Averaging Method (Internal Revenue Code (IRC) Section 402(e)(4)(L)). On federal Form 4972, "Special 10-year Averaging Method", she elected to report the entire \$16,000 as ordinary income and deducted the \$5,000 death benefit exclusion against the \$16,000.

Section 71.05(1)(a)8, 1983 Wis. Stats., provides that any portion of a lump-sum distribution which is excluded from federal adjusted gross income under IRC Section 402(e) must be added back for purposes of determining a taxpayer's Wisconsin taxable income. A taxpayer who elects federally to treat the entire distribution as ordinary income may report the capital gain portion as capital gain income for Wisconsin.

If Taxpayer A elects to treat the \$4,000 as capital gain income for Wisconsin, how should she allocate the \$5,000 death benefit exclusion (IRC Section 101(b)) between the capital gain and ordinary income portions of the distribution?

Answer: The death benefit exclusion must be allocated between the ordinary income and capital gain portions of a lump-sum distribution in the following manner:

- A. Add the capital gain and ordinary income portions of the distribution to get the total taxable distribution.
- B. Divide the capital gain by the total taxable distribution computed in (A) to get a percentage.
- C. Subtract the death benefit exclusion from the total taxable distribution computed in (A) to get the net taxable distribution.
- D. Multiply the percentage computed in (B) by the net taxable distribution computed in (C). This is the taxable capital gain less the death benefit exclusion.
- E. Subtract the taxable capital gain computed in (D) from the net taxable distribution computed in (C). This is the taxable ordinary income less the death benefit exclusion.

Taxpayer A must allocate the \$5,000 exclusion as follows:

- | | | | |
|----|-----------|--|--|
| A. | \$ 4,000 | Capital Gain Income | |
| | + 12,000 | Ordinary Income | |
| | \$ 16,000 | Total Taxable Distribution | |
| B. | \$ 4,000 | Capital Gain | |
| | ÷ 16,000 | Total Taxable Distribution | |
| | 25% | Capital Gain Percentage | |
| C. | \$ 16,000 | Total Taxable Distribution | |
| | - 5,000 | Death Benefit Exclusion | |
| | \$ 11,000 | Net Taxable Distribution | |
| D. | \$ 11,000 | Net Taxable Distribution | |
| | × 25% | Capital Gain Percentage | |
| | \$ 2,750 | Taxable Capital Gain Less Exclusion | |
| E. | \$ 11,000 | Net Taxable Distribution | |
| | - 2,750 | Taxable Capital Gain Less Exclusion | |
| | \$ 8,250 | Taxable Ordinary Income Less Exclusion | |

2. Credit for Taxes Paid to Other States - New York Minimum Income Tax

Statutes: section 71.09(8)(c), 1983 Wis. Stats.

Facts and Questions: The taxpayer pays a minimum income tax of \$3,000 to New York based on the 60% capital gain deduction (i.e., that portion of the capital gains which are not subject to the New York income tax). May this New York minimum income tax payment based on this 60%

capital gain deduction be claimed as a credit against Wisconsin income tax pursuant to s. 71.09(8)(c), 1983 Wis. Stats.?

Answer: Section 71.09(8)(c), 1983 Wis. Stats., requires that certain conditions be met before a credit may be claimed for taxes paid to another state. One of these conditions is that a net income tax must be paid to another state upon income taxable by such state. Also, the credit is not allowable unless the income taxed by the other state is also considered income for Wisconsin tax purposes.

The New York minimum income tax meets the above two conditions for years prior to 1984. However, since Wisconsin taxed only 80% of capital gains in 1982 and 60% in 1983, a taxpayer does not get full credit for the New York minimum income tax for either of those years. Rather, credit is allowed for 2/3 of the New York minimum income tax for 1982 since 2/3 of the 60% capital gain deduction subject to the New York minimum income tax is considered income for Wisconsin. Credit under s. 71.09(8)(c), 1983 Wis. Stats., is allowed for 1/3 of the New York minimum income tax for 1983. (Note: If New York had a minimum tax rather than a minimum income tax, none of the payment to New York would be allowed as a credit under s. 71.09(8)(c) since the payment would not be an income tax paid to New York but rather a minimum tax.)

For 1984 and thereafter, no credit would be allowed for the New York minimum income tax since no part of the 60% capital gain deduction subject to the New York minimum income tax is considered income for Wisconsin.

3. Section 179 Deduction Available for Married Persons

Statutes: sections 71.01(1), 71.02(2)(b) and (e), 1983 Wis. Stats. section 71.02(2)(d)11, 1985 Wis. Stats.

Facts and Question: Under Section 179 of the Internal Revenue Code, all taxpayers, except trusts, estates and certain noncorporate lessors, may elect to expense certain depreciable business assets purchased and placed in service in taxable years beginning after 1981. For the taxable years 1982 through 1985, single persons and married persons filing joint federal returns may elect to expense up to \$5,000 of Section 179 property. (Note: Prior to its amendment in 1984 by Public Law 98-369, the Section 179 deduction was scheduled to increase to \$7,500 for taxable years 1984 and 1985.) Married persons filing separate federal returns may each claim up to one-half of the amount available to married persons filing joint federal returns (\$2,500 for each of the years 1982, 1983, 1984 and 1985).

Section 71.02(2)(e), 1983 Wis. Stats., provides that Wisconsin adjusted gross income means federal adjusted gross income with certain prescribed modifications. For the 1982 taxable year, federal adjusted gross income is determined under the Internal Revenue Code in effect on December 31, 1981 (s. 71.02(2)(b)8, 1983 Wis. Stats.). For the 1983 taxable year, federal adjusted gross income is determined under the Internal Revenue Code in effect on December 31, 1982 (s. 71.02(2)(b)9, 1983 Wis. Stats.). For the 1984 taxable year, federal adjusted gross income is determined under the Internal Revenue Code in effect on December 31, 1983 (s. 71.02(2)(b)10, 1983 Wis. Stats.). For the 1985 taxable year, federal adjusted gross income is determined

under the Internal Revenue Code in effect on December 31, 1984 (s. 71.02(2)(d)11, 1985 Wis. Stats.).

What are the maximum Section 179 deductions available to married persons filing Wisconsin income tax returns for the years 1982, 1983, 1984 and 1985?

Answer: Since a husband and wife are considered separate taxpayers under s. 71.01(1), 1983 Wis. Stats., married persons filing Wisconsin income tax returns for the years 1982, 1983, 1984 and 1985 are limited to the Section 179 deductions available to married persons filing separate federal returns. The amount of deduction available each year is determined under the Internal Revenue Code in effect for that taxable year. Thus, the maximum Section 179 deduction available to each spouse is \$2,500 in 1982 and 1983, \$3,750 in 1984 and \$2,500 in 1985.

Example 1: A husband and wife file a 1985 Wisconsin income tax return. On their 1985 federal return, the husband claims a \$5,000 Section 179 deduction for machinery used in his business. For Wisconsin, the maximum Section 179 deduction that the husband may claim is \$2,500, the amount available to married persons filing separate federal returns. The wife may not claim any part of her husband's Section 179 deduction.

Example 2: A husband and wife file a 1984 Wisconsin income tax return. On their 1984 federal return, the wife claimed a \$5,000 Section 179 deduction. For Wisconsin, the maximum Section 179 deduction that the wife may claim is \$3,750, the amount available to married persons filing separate federal returns under the December 31, 1983 Internal Revenue Code. The husband may not claim any part of his wife's Section 179 deduction.

Example 3: A husband and wife file a 1984 Wisconsin income tax return. On their 1984 federal return, the husband claimed a \$5,000 Section 179 deduction for farm equipment. For Wisconsin, the maximum Section 179 deduction that the husband may claim is \$3,750, the amount available to married persons filing separate federal returns under the December 31, 1983 Internal Revenue Code. Since the wife also purchased business assets during 1984 which would qualify for the Section 179 deduction, she may also claim a maximum Section 179 deduction of \$3,750 on her 1984 Wisconsin return.

4. Using the Section 179 Deduction to Create the Same Depreciable Basis for Wisconsin and Federal Purposes for Individuals

Statutes: section 71.02(2)(b)10, 1983 Wis. Stats.

Note: See the Tax Release titled "Wisconsin Basis of Investment Tax Credit Property" in *Wisconsin Tax Bulletin #35* and "Section 179 Deduction Available for Married Persons" in this Bulletin.

Background:

A. Basis of Investment Tax Credit Property

For federal purposes, individuals who elect the full 10% investment tax credit on property placed in service after

December 31, 1982 must reduce the depreciable basis of the property by one-half of such credit. For Wisconsin income tax purposes, the basis of such property does not have to be reduced when the 10% federal investment tax credit is claimed.

B. Section 179 Expense Deduction

For federal purposes, individuals may elect to treat part of the cost of qualifying property as an expense rather than as a capital expenditure (Internal Revenue Code Section 179). The maximum Section 179 expense deduction allowed federally for 1984 is \$5,000 for single persons and married persons filing jointly and \$2,500 each for married persons filing separately.

For 1984, Wisconsin follows the Internal Revenue Code in effect as of December 31, 1983. Therefore, the maximum Section 179 expense deduction allowed on 1984 Wisconsin income tax returns is \$7,500 for single persons and \$3,750 for each spouse for married persons.

Example: During 1984 a single person purchased and placed in service equipment which cost \$20,000. The equipment is in the 5-year ACRS recovery class. The taxpayer claimed the 10% federal investment tax credit of \$2,000 on this equipment. This individual's federal depreciable basis for 1984 is \$19,000 (\$20,000 minus one-half of the \$2,000 investment tax credit). Since the individual used the full cost of the property to compute the investment tax credit, no Section 179 expense deduction is available for federal purposes.

If a Section 179 expense deduction is not claimed or allowed for Wisconsin purposes, the individual's depreciable basis for 1984 is \$20,000, the cost of the equipment. The individual in this instance would be required to maintain separate depreciation records for Wisconsin and federal income tax purposes.

Question 1: May this individual elect to claim a \$1,000 Section 179 expense deduction on this property on his or her Wisconsin income tax return, thereby creating the same depreciable basis of \$19,000 (\$20,000 - \$1,000) for 1984 for Wisconsin and federal purposes?

Answer 1: Yes. Since the Section 179 expense deduction is an *election* available under the Internal Revenue Code, an individual may elect to use this expense deduction on qualifying property on the individual's Wisconsin return even though the same election is not claimed on the federal return. In the above example, the individual could claim a \$1,000 Section 179 expense on his or her Wisconsin return for 1984, provided the maximum Section 179 expense deduction was not claimed on other business assets purchased and placed in service in 1984. This individual will then have a \$19,000 depreciable basis for Wisconsin and federal purposes for 1984, and the same depreciation deductions may be claimed on the individual's federal and Wisconsin returns for 1984 and thereafter. The individual will not have to maintain separate depreciation records for Wisconsin.

Question 2: If the individual in the above example elects to claim the \$1,000 Section 179 expense deduction for Wisconsin, how should the individual report this difference on the Wisconsin return?

Answer 2:

- A. If the Section 179 expense deduction affects other amounts on the federal return.

Since the Section 179 expense deduction claimed for Wisconsin will affect the computation of federal adjusted gross income, it may also affect other items of income or deduction which are based on federal adjusted gross income (such as taxable unemployment compensation, itemized deduction for medical expenses). If the Section 179 deduction claimed for Wisconsin does affect other income or deductions, the individual must submit with the Wisconsin Form 1 a revised federal Form 1040 and accompanying schedules which reflect the \$1,000 Section 179 expense deduction claimed only for Wisconsin income tax purposes. In this situation, the federal return filed with Wisconsin will *not* be identical to the federal return filed with the Internal Revenue Service.

The amounts on lines 5 through 25 and 37 of the 1984 Wisconsin Form 1 will be taken from the revised federal return which reflects the Section 179 expense deduction being claimed for Wisconsin.

- B. If the Section 179 expense deduction does not affect other amounts on the federal return.

The individual should report on lines 5 through 25 and 37 of the 1984 Wisconsin Form 1 the amounts as they appear on the federal return filed with the Internal Revenue Service. On line 34 of the 1984 Wisconsin Form 1, the individual should write "Section 179 expense claimed for Wisconsin only" and claim a subtraction modification for \$1,000. A schedule must be attached to the Wisconsin return identifying the specific items to which the Section 179 election applies and the part of the cost of each item the individual elects to deduct as an expense.

Note: Although the taxpayer in this example elected only \$1,000 of Section 179 expense on the Wisconsin income tax return, \$7,500 Section 179 expense could have been deducted on the 1984 Wisconsin income tax return. The Wisconsin depreciable basis would then be \$12,500 (\$20,000 - \$7,500) and the taxpayer would be required to maintain separate depreciation records for Wisconsin income tax purposes.

If the taxpayer in this example had been an estate or a trust, the Section 179 expense would not be allowed. For federal and Wisconsin tax purposes, estates, trusts, and certain noncorporate lessors do not qualify for the Section 179 expense deduction.

CORPORATION FRANCHISE/INCOME TAXES

1. Accounting for Accrued Expenses of a Corporation

Statutes: sections 71.04(7) and (12), 71.041 and 71.11(8), 1983 Wis. Stats.

Facts and Question: The Federal Tax Reform Act of 1984 made several changes to the timing of an accrued expense for federal income tax purposes. Since Wisconsin corporate franchise/income tax law is not generally federalized, these changes do not apply to Wisconsin and may create differences between federal and Wisconsin treatment of accrued expenses. Contributions to pension plans are an exception, as described below.

What is the federal and Wisconsin treatment of accrued expenses?

Answer: Following is a summary of federal and Wisconsin treatment of accrued expenses.

A. General Rules

- (1) Federal Law - Section 461(h), Internal Revenue Code, effective for amounts deductible after July 18, 1984.

Under the accrual method of accounting, an expense was deductible in the taxable year in which all events occurred which determined, with reasonable accuracy, both the fact and amount of the liability. This "all events test" has been modified to provide that all of the events that establish liability for an item during a taxable year may not occur earlier than the time of "economic performance" Generally, economic performance occurs when the activities that must be performed to satisfy a liability are, in fact, performed. For example:

(a) In the case of a taxpayer's liability that requires a payment for property or services, economic performance occurs as the property or services are provided to the taxpayer.

(b) If the taxpayer's liability requires the taxpayer to provide services or property, economic performance occurs as the taxpayer provides the services or property.

(c) In the case of a taxpayer's liability to another person arising under worker's compensation laws or out of any tort, economic performance occurs as payments to that person are made.

There are several exceptions to the economic performance test. The requirement does not apply to the liability of a taxpayer providing benefits to employees under qualified pension and profit sharing plans. The requirement is also inapplicable to contributions to a funded welfare benefits plan as well as to items that are covered by other Internal Revenue Code sections such as deductions for additions to bad debt reserves.

Also, certain items are treated as incurred in a taxable year if (a) the all events test is met, (b) economic performance occurs within a reasonable period (but limited to 8 1/2 months after the end of the taxable year), (c) the item is recurring and the tax treatment is consistent, and (d) the item is not material and accrual during the year results in better matching against income. In determining whether an item is recurring and consistently treated, items incurred in starting up a business and items not occurring each and every year may be considered.

Finally, special elections permit deductions in advance of economic performance. Where a taxpayer elects to adopt a uniform method of deducting qualified reclamation and closing costs associated with certain mining and solid waste disposal properties, or to deduct contributions to a qualified nuclear decommissioning reserve fund, the economic performance rule does not apply.

- (2) Wisconsin Law - Sections 71.04(7) and 71.11(8), 1983 Wisconsin Statutes.

Taxable income must be computed using a method of accounting which clearly reflects income. A method of accounting will not be regarded as clearly reflecting income unless all items of gross income and deduction are treated

with reasonable consistency. Reserves for contingent losses or liabilities are not deductible.

The accrual method of accounting attributes items of income to the year in which earned. Items of deduction are attributed to the year in which all events necessary to establish liability for their payment have occurred. An accrual basis taxpayer may deduct the amount of an accrued expense when the liability becomes fixed and determinable.

B. Related Party Transactions

- (1) Federal Law - Section 267, Internal Revenue Code, effective for taxable years beginning after December 31, 1983.

An accrual basis taxpayer may deduct expenses and interest owed to a related cash basis person when payment is made and the amount is includable in the gross income of the recipient. A related taxpayer includes (a) members of a family, (b) an individual and a corporation more than 50% in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual, (c) two corporations that are members of the same controlled group, (d) a fiduciary of a trust and a corporation more than 50% in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust, (e) a person and an organization to which Section 501 applies and which is controlled directly or indirectly by such person, (f) a corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the interest in the partnership, (g) an S corporation and another S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation, or (h) an S corporation and a C corporation if the same persons own more than 50% in value of the outstanding stock of each corporation.

- (2) Wisconsin Law - Section 71.04(12), 1983 Wisconsin Statutes.

Whenever the recipient is a cash basis taxpayer, generally no deduction is allowed for accrued wages, salaries, bonuses, interest or other expenses if not paid within 2 1/2 months after the close of taxable year to an officer of a corporation or to a shareholder of a corporation who owns more than 20% of the outstanding voting stock. Any amount disallowed under this section is deductible when ultimately paid.

C. Accrued Vacation Pay

- (1) Federal law - Section 463, Internal Revenue Code, effective for taxable years beginning after March 31, 1984.

A taxpayer may elect to deduct a reasonable addition to a reserve for vacation pay, representing the taxpayer's liability for contingent or vested vacation pay, earned by employees before the close of the current year and expected to be paid during the taxable year or within 12 months following the close of the taxable year.

- (2) Wisconsin Law - Section 71.04(7), 1983 Wisconsin Statutes.

Accrued vacation pay may be deducted only if the employee's right to the vacation vests in him or her as it is earned, so that the employee may never lose it. If the em-

ployee could lose the vacation pay, it is a contingent liability and, therefore, not deductible.

D. Pension Plan Contributions

- (1) Federal Law - Sections 401 and 404, Internal Revenue Code, existing law unchanged by the Federal Tax Reform Act of 1984.

Contributions to qualified pension plans are deemed to have been made on the last day of the preceding taxable year if the payment is on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year, including extensions.

- (2) Wisconsin Law - Section 71.041, Wisconsin Statutes.

Wisconsin follows the federal treatment for deducting qualified pension plan contributions. (Section 71.041 was enacted by 1983 Wisconsin Act 405 and applies to plan years beginning after September 2, 1974 that are open to adjustment on or after the effective date of the Act, May 10, 1984.)

2. Expenses Related to Wholly Exempt Income

Statutes: section 71.04(2)(b)9, (4)(b) and (7m), 1983 Wis. Stats.

Note: This Tax Release applies only with respect to taxable years 1983 and thereafter.

Facts: Section 71.04(2)(b)9 and (7m), 1983 Wis. Stats., effective for the taxable year 1983 and thereafter, does not allow deductions related to "wholly exempt income". Wholly exempt income for corporations subject to Wisconsin franchise or income tax includes amounts received from affiliated or subsidiary corporations for interest, dividends or capital gains that, because of the degree of common ownership, control or management between the payor and payee, are not subject to taxation under Chapter 71. Interest on obligations of the United States is included in "wholly exempt income" for a corporation subject to the income tax.

In 1983, Corporation X received \$1,000 in dividends from Corporation Y, a non-unitary subsidiary, and \$5,000 in dividends from Corporation Z, a unitary subsidiary. Both Corporation Y and Corporation Z are wholly owned subsidiaries of Corporation X. Because Corporation Y is a non-unitary subsidiary of Corporation X, the \$1,000 in dividends Corporation X received from Corporation Y is exempt from taxation under Chapter 71. The \$5,000 in dividends Corporation X received from Corporation Z is not exempt under Chapter 71 but would be deductible to the extent of \$2,500 under s. 71.04(4)(b), 1983 Wis. Stats.

Question 1: Does "wholly exempt income" for Corporation X include the \$2,500 in deductible dividends under s. 71.04(4)(b), 1983 Wis. Stats., received from Corporation Z in addition to the \$1,000 in dividends received from the non-unitary subsidiary Corporation Y?

Answer 1: Section 71.04(2)(b)9, 1983 Wis. Stats., does not apply to the \$2,500 dividends deductible under s. 71.04(4)(b) because of the definition of "wholly exempt income." Section 71.04(2)(b)9, 1983 Wis. Stats., states that wholly exempt income does not include income excludable, exempt or deductible under specific provisions of Chapter 71. In this case, only the \$1,000 would be considered "wholly exempt income".